No. 06-234

In the Supreme Court of the United States

INFORMATION SYSTEMS & NETWORKS CORPORATION,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

NICHOLAS P. RETSON
Acting General Counsel

E. MICHAEL CHIAPARAS
Chief Trial Attorney

GREGORY T. ALLEN
Trial Attorney
Defense Contract Management Agency
Manassas, VA 20109

PAUL D. CLEMENT
Solicitor General
Counsel of Record

PETER D. KEISLER
Assistant Attorney General

DAVID M. COHEN
ANTHONY J. STEINMEYER
MARK A. MELNICK
TIMOTHY P. MCILMAIL
Attorneys

Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

QUESTION PRESENTED

In Maryland, the shareholder of an S corporation pays personal income tax on her pro rata share of the corporation's gross income. The question presented is whether 48 C.F.R. 31.205-41 requires the government to reimburse petitioner, an S corporation and government contractor, for payments it made under a separate agreement with its sole shareholder, reimbursing her for the portion of her Maryland state income tax payments attributable to petitioner's income on its government contracts.

TABLE OF CONTENTS

Page

Opinions below 1
Jurisdiction 1
Statement 2
Argument 4
Conclusion 8

TABLE OF AUTHORITIES

Cases:

Cedric Kushner Promotions, Ltd. v. *King*, 533 U.S. 158 (2001) 5
Domino's Pizza v. *McDonald*, 126 S. Ct. 1246 (2006) 5
FCC v. *Beach Commc'ns, Inc.*, 508 U.S. 307 (1993) 7
Grupo Mexicano de Desarrollo, S.A. v. *Alliance Bond Fund, Inc.*, 527 U.S. 308 (1999) 7
Marquardt Co. v. *United States*, 822 F.2d 1573 (Fed. Cir. 1987) 5
Riverside Research Inst. v. *United States*, 860 F.2d 420 (Fed. Cir. 1988), modified on reh'g, 877 F.2d 952 (Fed. Cir. 1989) 5

Statutes and regulations:

26 U.S.C. 1362 2
26 U.S.C. 1363(a) 2
26 U.S.C. 1366 2
26 U.S.C. 1366(c) 2
Md. Code Ann., Corps. & Ass'ns, § 3-503(a)(2) (1999) 6

Statutes and regulations—Continued: Page

Md. Code Ann., Tax-Gen. (2004):
§ 10-102.1(b) (Supp. 2006) 6
§ 10-102.1(c) (1) (Supp. 2006) 6
§ 10-104(6) 2, 5
§ 10-203 2
48 C.F.R.:
Section 16.301-1 2
Section 31.205-15(a) 7
Section 31.205-41(a) 3, 4
Section 31.205-41(a)(1) 2, 3
Section 31.205-41(b)(3) 2, 5

In the Supreme Court of the United States

No. 06-234

INFORMATION SYSTEMS & NETWORKS CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-10a) is reported at 437 F.3d 1173. The opinion of the Court of Federal Claims (Pet. App. 11a-30a) is reported at 48 Fed. Cl. 265.

JURISDICTION

The judgment of the court of appeals was entered on February 6, 2006. A petition for rehearing was denied on April 14, 2006 (Pet. App. 31a-32a). On July 11, 2006, the Chief Justice extended the time within which to file a petition for a writ of certiorari to and including August 14, 2006, and the petition was filed on that date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In the 1980s and 1990s, petitioner provided services to the federal government under cost-reimbursement contracts. Pet. App. 2a, 14a. A cost-reimbursement contract entitles a contractor to be reimbursed by the government for allowable costs incurred during performance of the contract. 48 C.F.R. 16.301-1. Besides the costs of material and labor, allowable costs also include state taxes "that are required to be and are paid" by the contractor, 48 C.F.R. 31.205-41(a)(1), unless the state taxes are, *inter alia*, taxes "from which exemptions are available to the contractor directly," 48 C.F.R. 31.205-41(b)(3).

2. Petitioner is a Maryland corporation with a single shareholder, Roma Malkani. Pet. App. 2a. Petitioner elected to be an S corporation under 26 U.S.C. 1362. Pet. App. 3a. S corporations are exempt from the federal corporate income tax, 26 U.S.C. 1363(a), and the Maryland state income tax, Md. Code Ann., Tax-Gen. § 10-104(6) (2004). A shareholder of an S corporation, however, pays federal income tax on his pro rata share of the corporation's income. See 26 U.S.C. 1366. Maryland also taxes a shareholder of an S corporation for his pro rata share of the corporation's income: specifically, Maryland bases its income tax on an individual's federal adjusted gross income, Md. Code Ann., Tax-Gen. § 10-203 (2004), which includes the pro rata share of the gross income of any S corporation for which he is a shareholder, 26 U.S.C. 1366(c).

Because petitioner is an S corporation, petitioner paid no federal or state income taxes on the income it received on its federal cost-reimbursement contracts. As petitioner's sole shareholder, Malkani paid income

taxes to Maryland on her pro rata share—*i.e.*, the entirety—of petitioner's income. Pet. App. 4a. Petitioner and Malkani had a side agreement pursuant to which petitioner agreed to pay Malkani money equal to the amount of her income tax payments attributable to petitioner's income. See *id.* at 12a; Pet. 5 ("[T]here was a valid, binding agreement between [petitioner] and its sole shareholder, Ms. Malkani, which obligated [petitioner] to reimburse her for the state income taxes she paid.").

3. Under its cost-reimbursement contracts, petitioner requested reimbursement from the government for the money petitioner paid Malkani under their separate agreement. Pet. App. 4a. Petitioner's request was denied, so petitioner brought this suit in the Court of Federal Claims, seeking a declaration that its payments to Malkani were allowable costs under the cost-reimbursement contracts. *Id.* at 5a. The Court of Federal Claims agreed and granted summary judgment to petitioner. *Id.* at 11a-30a. In its decision on damages, the court held that $1,133,176 of the money petitioner had reimbursed Malkani were allowable costs under petitioner's contracts. *Id.* at 5a.

4. The Federal Circuit reversed. Pet. App. 1a-10a. It based its decision on 48 C.F.R. 31.205-41(a), which provides that "The following types of costs are allowable: * * * State * * * taxes * * * that are required to be and are paid." The court of appeals held that "[t]he allowable taxes described in 48 C.F.R. § 31.205-41(a) apply to taxes paid by the contracting entity. As an S corporation, [petitioner] never paid any state income taxes. Only Ms. Malkani paid state income taxes." Pet. App. 7a.

ARGUMENT

The decision of the court of appeals is correct and addresses a straightforward issue of regulatory interpretation. Petitioner cites no decision of this Court or any other court of appeals that conflicts with the decision below. Accordingly, this Court's review is not warranted.

1. Petitioner argues (Pet. 5) that its payments to Malkani are allowable costs of performing its government cost-reimbursement contracts. Petitioner's payments to Malkani, however, were not costs it had to pay in order to fulfill its government contracts; instead, they were payments on its separate agreement with Malkani. Petitioner tries (Pet. 13-16) to link its cost-reimbursement contracts to its agreement with Malkani by reasoning that Malkani's tax liabilities were actually petitioner's own tax liabilities on its government contract, which had been "passed through" or "transferred" to Malkani. Thus, petitioner concludes, the government must reimburse it for the payments under 48 C.F.R. 31.205-41(a), which establishes the terms under which the government reimburses contractors for tax liabilities they incur in performing government contracts.

The court of appeals correctly held that 48 C.F.R. 31.205-41(a) does not apply to state income taxes incurred by a shareholder of an S corporation; rather, it applies only to taxes incurred and paid by the contracting entity. Pet. App. 6a-7a. As the court held, Malkani—not petitioner—incurred and paid the Maryland state taxes at issue in this case, and "[b]ecause she is not the contracting entity, 48 C.F.R. § 31.205-41 is inapplicable to Ms. Malkani's state income tax payments." *Id.* at 7a-8a. The court of appeals' decision re-

flects the elementary notion that a corporation and its sole shareholder are "legally different entit[ies] with different rights and responsibilities due to [their] different legal status." *Cedric Kushner Promotions, Ltd.* v. *King*, 533 U.S. 158, 163 (2001); cf. *Domino's Pizza, Inc.* v. *McDonald*, 126 S. Ct. 1246, 1250 (2006) ("[I]t is fundamental corporation and agency law—indeed, it can be said to be the whole purpose of corporation and agency law—that the shareholder * * * of a corporation has no rights and is exposed to no liability under the corporation's contracts."). The court's decision, furthermore, is consistent with its precedents upholding "the unexceptional proposition that a cost may not be charged against the government unless that cost is actually incurred by the contractor." *Riverside Research Inst.* v. *United States*, 860 F.2d 420, 424 (Fed. Cir. 1988) (discussing *Marquardt Co.* v. *United States*, 822 F.2d 1573 (Fed. Cir. 1987)), modified on reh'g, 877 F.2d 952 (Fed. Cir. 1989).

Even if petitioner, ignoring corporate formalities, were correct that its payments to Malkani were effectively payments of its own state income taxes because an S corporation, its shareholders, and their respective tax liabilities are "intermingled and intertwined" (Pet. 16), 48 C.F.R. 31.205-41(b)(3) states clearly that taxes "from which exemptions are available to the contractor directly" are not allowable costs. Petitioner, as an S corporation, is expressly exempted from the Maryland state income tax—*i.e.*, it neither incurs nor pays Maryland state income tax. See Md. Code Ann., Tax-Gen. § 10-104(6) (2004). The court of appeals correctly held (Pet. App. 6a-7a) that, even on petitioner's view, petitioner's Maryland state income tax exemption would trigger 48 C.F.R. 31.205-41(b)(3) such that petitioner

could not be reimbursed for money, no matter how circuitously paid, spent on Maryland state income taxes.

Petitioner's intermingling argument, moreover, is patently incorrect. Petitioner contends (Pet. 17) that, because some States require S corporations to pay state income taxes levied on their shareholders "either in the form of a corporate-level tax or in the form of a withholding tax," Malkani's Maryland income tax payments should be treated as the petitioner's own. As the Court of Federal Claims determined (Pet. App. 30a n.14), none of those state statutes actually applies to petitioner. Maryland, to be sure, does require Maryland S corporations to withhold with respect to *nonresident* shareholders. See Md. Code Ann., Tax-Gen. § 10-102.1(b) (Supp. 2006). Not only is that statute inapplicable in this case because Malkani was not a nonresident, see Gov't C.A. App. 57, but a state withholding requirement does not affect the incidence of the underlying tax. The Maryland statute is clear on that matter, for it expressly provides that the tax "shall be treated as a tax imposed on the nonresident," not the S corporation. Md. Code Ann., Tax-Gen. § 10-102.1(c)(1) (Supp. 2006).

Petitioner also argues (Pet. 17) that some States provide a "potential penalty" or an encumbrance on an S corporation's ability to do business in that State if the corporation's shareholders fail to pay state income taxes. Although Maryland law provides that a Maryland corporation can have its charter "repealed, annulled, and forfeited" if it does not pay *its* state taxes, Md. Code Ann., Corps. & Ass'ns § 3-503(a)(2) (1999), that remedy does not extend to the failure of the corporation's shareholders to pay *their* personal state taxes. Even if Maryland did penalize an S corporation for its shareholders' tax delinquencies, moreover, a different regulation, as

the court of appeals noted (Pet. App. 8a-9a), makes a government contractor's payment of penalties and fines an unallowable cost. See 48 C.F.R. 31.205-15(a).

2. Petitioner also contends (Pet. 22-23) that, as construed by the court of appeals, the applicable regulation violates equal protection because it treats S corporations differently than traditional corporations. Review of this argument is unwarranted because it was neither raised nor considered below. *Grupo Mexicano de Desarrollo, S.A.* v. *Alliance Bond Fund, Inc.*, 527 U.S. 308, 318 n.3 (1999).

In any event, the premise of petitioner's claim is invalid because there is no unequal treatment. State taxes paid by any corporation, regardless of the corporation's type, are allowable costs to the extent the corporation can demonstrate that it incurred and paid the taxes, and state taxes paid by any corporation's shareholders are not allowable costs. Moreover, even if the purported unequal treatment existed, petitioner has not contended, and could not establish, that such inequality lacks a rational basis. See *FCC* v. *Beach Commc'ns, Inc.*, 508 U.S. 307, 313 (1993) ("In areas of social and economic policy, a statutory classification that neither proceeds along suspect lines nor infringes fundamental constitutional rights must be upheld against equal protection challenge if there is any reasonably conceivable state of facts that could provide a rational basis for the classification.").

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

PAUL D. CLEMENT
Solicitor General

PETER D. KEISLER
Assistant Attorney General

DAVID M. COHEN
ANTHONY J. STEINMEYER
MARK A. MELNICK
TIMOTHY P. MCILMAIL
Attorneys

NICHOLAS P. RETSON
Acting General Counsel

E. MICHAEL CHIAPARAS
Chief Trial Attorney

GREGORY T. ALLEN
Trial Attorney
Defense Contract Management Agency

DECEMBER 2006